The cross border supply of services and the need to harmonise the VAT rules that apply

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An analysis of the VAT treatment of cross-border imported services in Africa and the prevalence of double VAT taxation as a result of uncoordinated unilateral measures – as compared to the harmonised approach in the European Community – with specific regard to the possible means by which to remove the incidence of double VAT taxation, and the possibility to move towards a more harmonised approach in Africa.

Abstract

Different Value Added Tax (**VAT**) jurisdictions often use different rules to determine which of them have the right to tax a specific transaction. This automatically results in the risk of double taxation, which can negatively impact trade; and under-taxation, which places pressure on governments, particularly of developing countries, by limiting the revenue available for collection. VAT is a major source of revenue for governments, however, the application of VAT in the context of cross-border transactions, particularly with regard to imported services creates difficulties. The cross-border trade of goods is well controlled in that when a transaction involves goods being moved from one jurisdiction to another, the goods are generally taxed where they are delivered. Further, customs duties tend to be collected at the same time as VAT on imports when goods cross borders, creating certainty in this regard.

Services cannot be subject to border controls in the same way as goods, which makes the charging and collection of VAT in these instances more complex. In many jurisdictions, VAT is collected on the cross-border supply of services via the reverse charge mechanism. This mechanism transfers the liability for the payment of VAT to the local recipient of the service (ie the customer), which creates a situation where foreign suppliers are not required to register in these jurisdictions and accordingly decreases the cost of compliance – a key contributor to the principle of VAT neutrality[1]. In most cases, where the local recipient is liable for the payment of reverse charge VAT in respect of an imported service, a corresponding input tax credit is available where the service is on-supplied, resulting in a VAT neutral position for the local recipient.

The problem arises where the reverse charge mechanism is applied inconsistently from country to country – where in some instances the VAT accounted for on imported services cannot be claimed as a credit due on the supply. In such instances, the reverse charge VAT represents an actual cost to the recipient of the service, which will then invariably be on-charged to the final consumer. In such cases, VAT will be levied on VAT and the final consumer will be subject to double VAT taxation.

The Organisation for Economic Co-operation and Development (**OECD**) released the International VAT/GST Guidelines in April 2014 which has the "aim of reducing the uncertainty and risks of double taxation and unintended non-taxation that result from inconsistencies in the application of VAT in a cross-border context."[2] These guidelines are not aimed at providing detailed prescriptions for national legislation but rather seek to identify objectives and suggest means for achieving them. These Guidelines are an important step in initiating a more harmonised approach to VAT. While not binding, they represent the key principles of a successful VAT structure that should be inherent in all VAT legislation.

This paper is an analysis of the feasibility of implementing a harmonised approach to VAT in Africa, with particular regard to the application of the reverse charge mechanism, and the different means by which the incidence of double VAT taxation that results, can be prevented. This position is compared to that of the European Community (**EC**) in order to highlight the need for consistency in the application of VAT legislation of different African jurisdictions. The varying application of the reverse charge mechanism in African countries is one such example of how uncoordinated unilateral measures can result, and have the potential, not only to increase the cost of compliance and doing business in Africa, but also to create barriers and discourage, particularly, cross-border trade in services. By initiating a more harmonised approached to VAT legislation across Africa, the inconsistencies in the application of similar principles can be avoided, facilitating trade and easing the compliance burden on vendors.

[1] *VAT neutrality* is defined in the OECD International VAT/GST Guidelines as, *inter alia*, the absence of discrimination in a tax environment that is unbiased and impartial, and the elimination of undue tax burdens and disproportionate or inappropriate costs for businesses, at 10.

[2] OECD. 2014. *International VAT/GST* Guidelines, at Preface.

Abbreviations

Abbreviation	Meaning
B2B	Business-to-business
B2C	Business-to-consumer
EAC	East African Community
EC	European Community
EU	European Union
MAP	Mutual Agreement Procedure
OECD	Organisation for Economic Co-operation and Development
SARS	South African Revenue Service
Sixth directive	Sixth Council Directive of 17 May 1977 77/388/EEC
The Guidelines	OECD International VAT/GST Guidelines
VAT	Value Added Tax
VAT Act	Value Added Tax Act No. 89 of 1991
VAT directive	Council Directive 2006/112/EC

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Chapter 1: Introduction

1.1 Introduction

Value Added Tax (**VAT**), as a tax on consumption, is receiving greater prominence due to the nature of its operation and particularly its ease of collection. It is as a result of this, that governments are placing greater emphasis on the need for more effective and efficient VAT legislation; potential harmonisation across trade areas to allow for ease of collection; and more stringent and enforceable rules relating to cross-border trade.

The ease of transacting as a result of an increase in globalisation has prompted a growing need to develop and update existing legislation in line with advancements in technology and practice. The cross-border trade in services is an area that is receiving much attention due to the difficulty (and in some cases inability) to track the supply and provision of such services, particularly through electronic mediums.

The principal feature of any tax is being able to establish a connection between the subject matter of the tax and the taxing jurisdiction. It is as a result of the difficult application of this seemingly simple concept that the need for advancement and progression of legislation exists. The difficulty in establishing a clear connection, and in successfully being able to resolve conflicts relating to more than one jurisdiction laying claim to such a connection, results in a constant need to update legislation in line with advancements and identifiable threats that present themselves on a regular basis.

This connection, for income tax purposes, is attained through the taxing of income on a residence or source basis. That is, a state will tax the worldwide income of a person that is resident in that particular state, whilst a state will also tax income that is sufficiently linked to its jurisdiction (i.e. the source of the income).[3]

Conversely, one of the key characteristics of VAT is that it is a tax on consumption and should only tax consumption expenditure at the time that it is incurred. This creates an obvious difficulty where one is required to make predictions about where the use or consumption of particular goods or services are likely to take place before consumption occurs.[4] Therefore, consumption is required to be reliably determined at the time that the supply is made.

1.2 Research objective

Since the onset of globalisation, cross-border economic activities have increased significantly, placing far greater emphasis on, *inter alia*: the applicability of local VAT systems in a cross-border context; the means to resolve conflicts; and the ability of local VAT systems to interact fairly with one another in an effective and efficient manner. Further, with the significant influence that VAT can have over business decisions and transactions, there is a need for the development of mechanisms through which the treatment of such transactions cannot only be monitored, but through which disputes can be adjudicated and settled in a VAT neutral manner.

Revenue authorities have begun to realise the impact and contribution of which an efficient VAT system, from a tax revenue perspective, is capable. It is for this reason that there is a growing need for a greater level of coordinated guidance (or universal guidance) on the treatment of VAT, to provide jurisdictions with a mechanism to resolve disputes in this regard.

[3] Ecker, T. 2013. *A VAT/GST Model Convention,* at Chapter 2.3.
[4] Millar, R. 2008. *Jurisdictional Reach of VAT* in *VAT in Africa* (Krever, R. et al. 2008), at 178.

It is as a result of the absence of the above, and of internationally agreed principles, that conflicts relating to the VAT treatment of transactions arise.

In order to explain the difficulties faced in attempting to initiate coordinated measures, it is necessary to understand the reasons why such measures are necessary and how particular conflicts arise. This paper will present one such example of a disconnect in the application of a concept which, due to its varied application, in this case, results in an increased cost to the end consumer. The application of this principle results in a direct conflict with the principles of a VAT as set out in the OECD International VAT/GST Guidelines (**the Guidelines**). This paper will attempt to highlight the need for some form of harmonisation or coordination of legislation in the particular example presented.

The African countries selected demonstrate one such example of how the application of a specific VAT mechanism can differ fundamentally between trading countries within close proximity to one another, as well as the effect that such inconsistent application has on the potential of having trade relations.

The above position will be compared to the current treatment of the same rules within the European Union (**EU**), where a harmonised approach has been followed for the last 48 years. Through these comparative positions, this paper will attempt to demonstrate the need for a coordinated approach in the legislation.

Finally, this paper will attempt to highlight the various possibilities to resolve incidences of double VAT taxation and the feasibility of implementing such mechanisms.

1.3 Background - The destination and origin principles

As set out briefly above, the principal difference between an income tax and a VAT is the difference in their *distributive rules*[5]. Both income tax and VAT follow the *territoriality principle*[6], however the only relevant connecting factor for VAT purposes is that of consumption. Further to this, the Guidelines set out that "[t]he fundamental issues of economic policy in relation to the international application of the VAT is whether the levy should be imposed by the jurisdiction of origin or destination."[7]

The destination and origin principles are generally considered to be, from a VAT perspective, the income tax-equivalent of source and residence. It is the application of the destination principle in international trade that will generally lead to a *VAT neutral*[8] result.

In short, the distinction between the two involves "taxing at a place *from which* supplies are made (the origin principle) and the taxing at the place *to which* supplies are made (the destination principle)."[9] (Emphasis added) In other words, "in the destination-based system the taxpayer pays VAT in the country of the destination of goods and services while in the origin-based system VAT is paid in the country of origin."[10]

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[5] A term used to describe the distribution of taxing rights between states.

[6] The territoriality principle is a "term used in the context of international taxation to connote the principle of levying tax only within the territorial jurisdiction of a sovereign tax authority or country. The underlying theory is that no taxes can be levied outside this area without violating the sovereign tax authority of another state. Consequently, both residents and non-residents of a state adopting this principle are only taxed on the income from sources in that country and on property situated in that country."(Ecker, T. 2013. *A VAT/GST Model Convention*, at Chapter 2.3).

[7] OECD. 2014. *International VAT/GST Guidelines*, at 7.

[8] The OECD International VAT/GST Guidelines set out that the concept of neutrality in VAT has a number of dimensions, but particularly the absence of discrimination in a tax environment that is unbiased and impartial and the elimination of undue tax burdens and disproportionate or inappropriate compliance costs for businesses. (OECD. 2014. *International VAT/GST Guidelines,* at Chapter 2).

[9] Millar, R. 2008. *Jurisdictional Reach of VAT* in *VAT in Africa* (Krever, R. et al. 2008), at 177.

[10] Kolozs, B. *Neutrality in VAT* in *Value Added Tax and Direct Taxation: Similarities and Differences* (IBFD. 2009), at Part IV (2).

It is through the application of the destination or origin principles that the incidence of double VAT (non-) taxation results, and it is this discrepancy which further results in a lack of VAT neutrality.

1.3.1 The destination principle

"[U]nder the destination principle, supplies taking place wholly within the jurisdiction are taxed, imports are taxed, and exports are zero-rated."[11] The destination principle is almost always the favoured principle for internationally traded services and intangibles which should consequently be taxed according to the rules of the jurisdiction of consumption. Further, a distinction is drawn between business-to-business supplies and business-to-consumer supplies. This distinction is necessary as a result of the staged-collection process of VAT and the fact that the destination principle "serves a crucial role in facilitating the ultimate taxation of internationally traded services and intangibles according to the rules of the jurisdiction of consumption."[12]

The Guidelines make provision for the destination principle in Guideline 3.1. They specifically set out that "for consumption tax purposes internationally traded services and intangibles should be taxed according to the rules of the jurisdiction of consumption."[13] The explanation further states that it is "designed to ensure that tax on services and intangibles traded internationally is ultimately levied only in the taxing jurisdiction where final consumption occurs, thereby maintaining neutrality within the VAT system with regard to international trade."[14]

Two of the main advantages of this principle are that in a Business-to-business (**B2B**) context, it ensures that such services are taxed according to the customer's jurisdiction, irrespective of from where they are supplied. It also ensures that businesses acquiring such services are driven by economic rather than tax considerations.[15]

1.3.2 The origin principle

Under the origin principle, "the tax burden on goods and services supplied for private consumption equals the sum of the value added in each country that contributed to the production and distribution of the goods or services, multiplied by the VAT rate applicable in each country."[16] In other words, "under the origin principle, the tax is levied in the various jurisdictions where the value was added."[17]

The application of the origin principle provides the same difficulties as that of the source rule for income tax purposes, namely that, in order to find successful application, the place of taxation rules must ensure the country from which the supply originates has and asserts jurisdiction to tax the supply.[18]

The origin principle operates in such a way that it treats imports and exports in the opposite way to that under the destination principle. Specifically, the origin principle charges VAT on all supplies with a domestic origin (exports), and denies an input tax

[11] Kolozs, B. *Neutrality in VAT* in *Value Added Tax and Direct Taxation: Similarities and Differences* (IBFD. 2009), at Part IV (2).
[12] OECD. 2014. *International VAT/GST Guidelines*, at 24.
[13] Ibid. Guideline 3.1, at 24.
[14] Ibid.
[15] Ibid.
[16] Cockfield, A. et al. 2013. *Taxing Global Digital Commerce*, at 68.
[17] OECD. 2014. *International VAT/GST Guidelines*, at 7.
[18] Cockfield, A. et al. 2013. *Taxing Global Digital Commerce*, at 69.

credit to non-residents in respect of outbound supplies. Further, imports and inbound transactions are not taxed, but the value must be excluded from future transactions to ensure that only the domestically-added value is taxed.[19]

1.4 Place of taxation rules for imported services

Services, and imported services in particular, have always been difficult to categorise into respective place of taxation rules as they cannot rely on the movement of goods across a border and must therefore rely on other methods to determine where consumption takes place.

The application of either the destination or origin principles in drafting VAT legislation means that in both cases one is required to make a determination as to the place of taxation of the supply. The most common *proxies*[20] that are used in this regard include residence, place of establishment, actual location, or a combination of these factors. It is clear, therefore, how the use of different proxies and concepts of location of consumption – and thus the place of taxation – can result in conflicts arising in cross-border transactions.

The principal characteristic that any place of taxation rules should aim to achieve is to be able to "identify the actual place of business use for business-to-business supplies, as well as the actual place of final consumption for business-to-consumer supplies."[21] Achieving this is, understandably, a fallacy, as transactions generally occur before the place of business use or consumption is even determined.

It is as a result of being unable to reliably determine the place of business use or consumption that proxies are used. These proxies are based on the features or characteristics of the supply that are known at the time that it is necessary to determine the tax treatment of the supply.[22]

1.5 The use of proxies

Due to the fact that there is no 'tangible movement' of services across a border, it is far more difficult to ascribe generic VAT legislation to these types of transactions. There are a number of standard proxies which are widely used, for example: the location; the residence or place of business of the supplier or recipient respectively; the location of the subject matter of the supply; the place of performance of the supply; and the location of something else to which the supply relates.[23] In addition to the above is the location, residence, or place of business of a person to whom the supply is provided, and the place of effective use or enjoyment of the goods. These function as somewhat of a 'catch-all category' in instances where the transaction-based proxies will not provide an accurate prediction of the place of consumption. This may occur, for instance, where the location of the recipient does not accurately reflect the place where consumption will occur.

Proxies also tend to be ranked according to their ability to correctly determine the place of consumption of a particular transaction. When it comes to services, "the place where the services are performed (which in some, but not all cases correlates with the place where they will be received)"[24] is the most favoured proxy. It is important, however, due to the staged-collection nature of a VAT, to distinguish between supplies made to other businesses for on-

[19] Cockfield, A. et al. 2013. *Taxing Global Digital Commerce*, at 69.

[20] Due to the difficulty in determining the place of consumption (which takes place, in most cases, far after a tax determination is required to be made), it is necessary to predict where consumption is most likely to take place at the time of supply. Proxies are therefore used in order to ensure certainty and clarity for transactions where the place of consumption might be difficult to determine. (Ecker, T. 2013. *A VAT/GST Model Convention,* at Chapter 11.1.1).

[21] OECD. 2014. *Discussion draft: Guideline on place of taxation for B2C supplies of services and intangibles*, at 4.

[22] Ibid.

[23] Millar, R. 2008. *Jurisdictional reach of VAT* in *VAT in Africa* (Krever, R. et al. 2008), at 183.

[24] Ibid, at 192.

supply (who are registered for VAT), and supplies made to the final consumer (and who will ultimately bear the cost of the VAT (ie will not be registered for VAT)).

1.5.1 Business-to-business (B2B) supplies

The Guidelines state that the main rule for B2B supplies is that "the jurisdiction in which the customer is located has the taxing rights over internationally traded services or intangibles."[25] This rule is closely related with the objective of neutrality by adhering strictly to the destination principle as set out above.

The most favoured proxy utilised in cases of B2B supplies is that the service is deemed to be consumed at the place where the recipient has its business presence. In these instances, the recommended collection mechanism for the VAT is by way of a reverse charge[26].It is important to note that as a result of the multi-staged collection nature of VAT, the taxing of B2B transactions is merely a "means of shifting the tax burden forward through the chain of production and distribution until it falls on a consumer."[27] It is for this reason that the reverse charge mechanism tends to find application in respect of the collection of VAT for cross-border B2B supplies of services.

The difficulty in the application of the main rule for B2B supplies arises in cases where supplies are made to an entity with multiple locations (ie where an entity has *establishments*[28] in multiple jurisdictions). For such entities it is necessary to determine the particular jurisdiction in which such an establishment exists, that will have taxing rights over the transaction. Guideline 3.4 of the Guidelines sets out that in such cases, the "taxing rights [will] accrue to the jurisdiction where the establishment using the services is located."[29] The 'use' refers to the use of a service for the purposes of its business operations.

In order to determine which establishment is regarded as using the service, a number of categories are suggested, namely: the direct use approach (ie taxing rights are allocated to the jurisdiction in which the service is used); the direct delivery approach (ie taxing rights are allocated to the jurisdiction to which the supplier delivers the service); and the recharge method (ie where the cost of a service will be recharged internally to the establishment that uses the service). The Guidelines conclude that "these approaches are not mutually exclusive and could be combined according to what information is available between the supplier and the customer."[30]

1.5.2 Business-to-consumer (B2C) supplies

In the case of B2C supplies, in order to determine the most effective proxy to utilise, a distinction must be drawn between 'on-the-spot' supplies (ie those which are

[25] OECD. 2014. *International VAT/GST Guidelines*, at 25.

[26] As will be discussed in Chapters 2.3 and 3.2 below, the reverse charge mechanism aims to shift the responsibility for paying output VAT from the supplier to the customer. The most common application of this mechanism entails a situation whereby the customer will account for output VAT on a purchase in its VAT return, whilst at the same time deducting the same amount of input tax. This means that no payment of output VAT in respect of a supply will be made to the tax authorities unless, for some reason, the customer does not have the full right to deduct input VAT. This will ensure that the VAT payable will move through the supply chain until it reaches the final consumer who will be unable to make the corresponding input deduction.

[27] Cockfield, A. et al. 2013. *Taxing Global Digital Commerce*, at 216.

[28] Each jurisdiction may have a differing domestic interpretation of what constitutes an establishment, however, for the purposes of the Guidelines, the OECD assumes that "an establishment comprises a fixed place of business with a sufficient level of infrastructure in terms of people, systems and assets to be able to receive/make supplies."(OECD. 2014. *International VAT/GST Guidelines*, at 27).

[29] Ibid, at Guideline 3.4.

[30] OECD. 2014. *International VAT/GST Guidelines*, at 29.

physically performed and ordinarily consumed at the same time at a readily identifiable location), and those supplies which can be consumed at a time other than at the time of performance (ie where consumption or performance is likely to be ongoing, or when such services are supplied remotely).[31]

The favoured approach in the latter case is that the place of consumption should be identified as the recipient's usual place of residence. According to the OECD, this is the place where the customer regularly lives or has established a home.[32] In the context of B2C supplies, the place of supply will depend to a large extent on factors such as the nature of the supply (ie the type and value) or any contracts in place or the delivery of the supply.

The major difficulty in determining the place of consumption, as set out above, is that a determination must be made and the place of supply must be reasonably known at a time prior to consumption. The OECD, in this regard, provides that "jurisdictions are encouraged to permit suppliers to rely, as much as possible, on information that they routinely collect from their customers in the course of their normal business activity, as long as such information provides reasonably reliable evidence of the place of usual residence of their customers."[33]

It is, therefore, through the use of appropriate proxies, as well as placing a reasonable reliance on the information obtained in the course of each supplier's normal business that the determination of the place of supply, and therefore the place of taxation, is determined.

1.6 VAT neutrality

The Guidelines state that the overarching purpose of VAT is a broad-based tax on final consumption (which is understood to mean final consumption by households). One of the objectives of a successful VAT system is that of neutrality. The Guidelines set out a number of dimensions to the concept of VAT neutrality, including "the absence of discrimination in a tax environment that is unbiased and impartial and the elimination of undue tax burdens and disproportionate and inappropriate compliance costs for businesses."[34]

Neutrality is a key aspect to tax policy. It is seen as one of the fundamental principles that should be inherent in all taxes, together with equity and efficiency. The Guidelines set out that the necessity for VAT neutrality stems from the need for impartiality and to have no influence on a taxpayer's choice as to where to conduct business. It is this characteristic which, in situations where imperfect VAT neutrality exists, leads to market distortions.[35]

This concept is therefore central to this paper as, in order to develop mechanisms to reduce the incidence, and in order to guard against double VAT (non-)taxation, and thereby introduce a greater degree of harmonisation, it is necessary to maintain a sufficient level of neutrality.

1.7 Harmonisation of VAT

As a result of the lack of universally recognised rules, such as those provided by the OECD from an income tax perspective, one finds that consumption taxes tend to differ considerably throughout the world. Despite the fact that similar concepts and principles are evident throughout consumption tax systems, it is the application and interpretation of these principles that create the disparity that has the potential to result in double taxation. Where

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[31] OECD. 2014. *Discussion Draft: International VAT/GST Guidelines – Guidelines on the place of taxation for business-to-consumer supplies of services and intangibles*, at 6 and 7.
[32] Ibid, at 8.
[33] Ibid.
[34] OECD. 2014. *International VAT/GST* Guidelines, at 10.
[35] Kolozs, B. 2009. *Neutrality in VAT* in *Value Added Tax and Direct Taxation: Similarities and Differences* (IBFD. 2009), at Part II.

– for example, place of taxation rules are interpreted differently, inconsistency in application relating to the use of proxies, or the classification of a particular transaction, an advantage – or disadvantage may be established leading to a distortion of competition stemming from a lack of neutrality.

It is as a result of the above, that a level of coordination is required when it comes to the application of consumption taxes in the context of cross-border transactions. There is a need for consumption tax systems to interact in a manner that is concomitant to the principles that are being introduced by the OECD in its Guidelines.

Harmonisation is one such way to achieve this. This paper will illustrate the functionality of the harmonised approach of the EU in contrast to the less developed, more common, unilateral interpretation and application that is so evident in many developing countries. In addition, potential methods of coordination will be examined as viable options to assist in ensuring that cross-border trade, and the consumption tax implications thereof, are fairly administered to avoid distortions of competition and allow for the neutrality concept envisaged by the OECD.

Chapter 2: VAT treatment of imported services in the EU – a harmonised approach

2.1 EU VAT system

The European Community (**EC**) moved to rationalise and harmonise both VAT rates and exemptions with the adoption of the Sixth Directive in 1977[36]. This directive set out all standards to which all community VAT laws were to conform, and was amended regularly and re-enacted in 2006 as the Council Directive 2006/112/EC.[37]

The effect of such legislation, in theory, was that the "fundamental substantive provisions of the tax [would be] common to all Member States"[38]. This meant that the domestic legislation of each Member State could be set out in any way, as long as the provisions of domestic legislation were not in conflict with EC guidelines. The object of such legislation was to "avoid conflicts of jurisdiction between EU Member States such that transactions affected are subject to VAT in one Member State only, as well as to ensure that all taxable transactions are taxed."[39]

The EU VAT system has therefore "been designed as a neutral system, which means, *inter alia*, that the VAT itself must not be a burden on taxable persons engaged in taxed transactions."[40] One of the salient features of this system is the integrated operation of its place of supply rules, which have the aim of establishing "unambiguously, a single place of supply for each transaction and so avoid both non-taxation and double taxation ideally with the tax accruing in the jurisdiction in which consumption takes place."[41]

2.2 Place of supply of services

Under the EU VAT system, a number of different place of supply rules determine which country has the right of taxation. The EU's place of supply rules are structured around two general rules and a number of particular provisions. The general rules, particularly in the context of this paper, are very relevant as they form the foundation on which a successful harmonised approach is able to operate when dealing specifically with the supply of services. The place of supply, based on these rules, will always determine the place of taxation.

2.2.1 The first general rule – B2B supplies

The first general rule defines the place of supply (and consequently the place of taxation) for B2B supplies as the place where the customer has *established his business*.[42] Of significance for the supply of services from B2B is the fact that such supplies are coupled with the *reverse charge mechanism*[43]. The application of the reverse charge in the EU system is no different from that applied universally in that the customer will be liable for payment of VAT whenever the supplier is not established within the territory of the customer's Member State.[44]

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[36] Sixth Council Directive of 17 May 1977 77/388/EEC.
[37] Krever, R. *et al*. 2008. *Design and Structure of the VAT* in *VAT in Africa* (Krever, R. et al. 2008), at 16.
[38] Bizioli, G. 2009. *Comparative Analysis of the Causes of Double (Non-) Taxation in the Income and VAT/GST Contexts* in *Value Added Tax and Direct Taxation: Similarities and Differences* (IBFD 2009), at par 2.
[39] Pelzer, M. and Vestero, C. 2009. *Allocation of Taxing Rights between States – Place Where the Supply/Activity Is Effectively Carried Out as Allocation Rule: VAT/GST v. Direct taxation* in *Value Added Tax and Direct Taxation: Similarities and Differences* (IBFD 2009), at Part II.
[40] Tzenova, L. 2014. *The Myth of the Neutrality of VAT* in *International VAT Monitor* (September/October 2014), at par 3.
[41] Goeydeniz, S. 2010. *IFA Research Paper: VAT on Cross-border Services*, at 10.
[42] Ibid, at Article 44.
[43] See Chapter 2.3 below for a discussion on the 'reverse charge in EU VAT'.
[44] Council of the European Union. *Council Directive 2006/112/EC*, at Article 196.

Clarification on *the place of business establishment* was provided under the EU Council Implementing Regulation No. 28/2011, which provides that it will be "the place where essential decisions concerning the general management of the business are taken, the place where the registered office of the business is located and the place where management meets".[45] It further provides that in the event that the place of business cannot be reliably determined based on these criteria, that the place of business will be "where essential decisions concerning the general management of the business are taken".[46]

However, there is an overriding rule to the above which states that if these services are provided to a fixed establishment of the customer located in a Member State other than the customer's place of business, the place of supply (ie place of taxation) is the place where that fixed establishment is located.[47]

2.2.2 The second general rule – B2C supplies

The second general rule defines the place of supply for B2C supplies as the place where the *supplier* has established its business.[48] This provision contains a proviso similar to that of B2B supplies above in that, if the services are supplied from a fixed establishment of the supplier in a Member State other than the supplier's place of business establishment, the place of supply (ie place of taxation) is the Member State where that fixed establishment is located.[49]

2.2.3 Application of the rules

As mentioned above, there are a number of specific rules which will cover a large number of scenarios and transactions. However, in the event that no specific rule relating to a particular supply applies, the two general rules set out above will find application. As a matter of course, what must first be decided is whether the transaction is B2B or B2C in nature, following which the appropriate general rule should then be applied.

The necessary distinction in this case would depend on whether the supply is being made to a taxable or non-taxable person. The simplest way of ascertaining the nature of the person to whom the supply is being made is whether such person has provided the supplier with a VAT number and that VAT number has been verified. Once this has been done – in accordance with the first general rule – one further determination will have to be made, namely, where the place of business or fixed establishment is located to which the supply is made.[50]

This determination is necessary as, in the event that the place of business or fixed establishment of the recipient is not in the same Member State as where the supplier is established, the VAT on the supply will be payable by the customer in the Member State in which it is located according to the reverse charge mechanism.

The above being said, there are a number of exceptions to the general rules and, in practice, "most services capable of being supplied across borders are already deemed to be supplied at the place where the recipient is established."[51]

[45] EU Council Implementing Regulation (EU) No. 282/2011 of 15 March 2011, at Article 10(1).
[46] Ibid.
[47] Council of the European Union. *Council Directive 2006/112/EC*, at Article 44.
[48] Ibid, at Article 45.
[49] Ibid, at Article 44.
[50] Cockfield, A. et al. 2013. *Taxing Global Digital Commerce*, at 305.
[51] Goeydeniz, S. 2010. *IFA Research Paper: VAT on Cross-border Services*, at 10.

The key proxy utilised for the purposes of determining the place of supply of a service is the place where the services are performed. This, in some cases relates to the place where the services will be received.

The default rule in the EU VAT system pertaining to the rendering of services to taxable persons is that "the transaction is taxed at the place where the customer is established, whereas services provided to non-taxable persons are deemed to take place where the supplier has established his business or has a fixed establishment from which the service is supplied."[52]

2.2.4 Supplier situated outside the EU

The default rule will still apply in such cases, in that the transaction is taxable at the place where the customer is established (in the case of a business customer), and where the supplier is established (in the case of a final consumer).

Where a service is provided to a non-taxable person from an EU supplier the exceptional rule will apply in that the transaction is deemed to take place where the customer is established. If this same service was provided by a third country supplier, the place where the supplier is established will have the taxing right.[53]

2.2.5 Place of supply in South Africa

The above principles and application can be contrasted to South African VAT legislation where there are no strict place of supply rules. The South African version of these rules veils itself in a two-tiered process to produce a similar result. This is achieved through section 7(1)(a) of the VAT Act, together with the definition of 'enterprise' as set out in section 1. Section 7(1)(a) imposes VAT on the supply by any vendor of goods and services in the course or furtherance of *any enterprise* carried on by him.[54] (Emphasis added) It is clear from the aforementioned that this step is the same for both goods and services. Thereafter, one needs to consider the definition of 'enterprise' for South African VAT purposes:

> *"an enterprise or activity which is carried on continuously or regularly by a person in the Republic or partly in the Republic in the course or furtherance of which goods or services are supplied to another person for a consideration, whether or not for profit."*[55]

It is clear from the above that, under South African VAT legislation, the place of supply rules manifest themselves as a mixture of the residence test (as is applied in the second general rule, ie where the supplier is located) and a place of performance test (as applied in the first general rule, ie where the customer is located). Therefore, despite the different approaches to the determination of the place of supply between the South African and EU systems, the underlying principles are characteristic of both.

2.3 Reverse charge in EU VAT

The reverse charge mechanism under the EU VAT model is, rather than how it is applied in the African context (for reasons that will be discussed in Chapter 3), a successful means of simplifying administration and compliance by shifting the responsibility for paying output VAT from the supplier to the customer.[56] The customer will account for output VAT on a purchase

[52] Ibid, at 5.
[53] Ibid, at 12 and 13.
[54] South Africa. *Value-Added Tax Act No. 89 of 1991*, at Section 7(1)(a).
[55] Ibid, at Section 1 "enterprise".
[56] Millar, R. *Jurisdictional Reach of VAT* in *VAT in Africa* (Krever, R. et al. 2008), at 192.

in its VAT return, whilst at the same time deducting the same amount of input VAT. This means that no payment of output VAT in respect of a supply will be made to the tax authorities unless, for some reason, the customer does not have the full right to deduct input VAT.

In this way, only the final B2C transaction would be subject to VAT and be obliged to remit the VAT to the tax authorities. The most advantageous aspect of this system is that no input tax refunds, whether in relation to domestic or cross-border transactions, will ever need to be paid out by the revenue authorities.[57]

As will be discussed by way of a practical example in Chapter 3, the application of the reverse charge mechanism between countries where no form of harmonisation, consistency or coordination exists in the implementation of their VAT legislation, has the ability to result in the incidence of double VAT taxation with regard to imported services in particular. However, the lack of continuity in these systems also leads to problems relating to compliance and collection of VAT. The successful application of the reverse charge mechanism is described as "an appropriate tax collection mechanism for cross-border transactions as the liability to pay VAT shifts to the customer, who especially in the case of 'importation' into the EU would be sizable."[58]

Variations of the reverse charge mechanism

There are two possible variations of the reverse charge mechanism, which demonstrate similar characteristics to the application in many of the African countries discussed below.

The most common of these variations is applied where all registered businesses (recipients of imported services) are required to account for VAT by means of the reverse charge rule.

The second variation is applied where (as is the case in South Africa) the reverse charge rule is only applied to businesses that do not use the imports to make fully taxable supplies.

The reverse charge provision applies in cases where, for example, non-EU suppliers render services to resident business customers. In these instances, the supplier cannot levy VAT to the customer, and accordingly, under the reverse charge provision, the customer must account for VAT on the services acquired from designated registered suppliers. They are, as mentioned above, entitled to deduct the same amount as input tax.[59]

2.4 EU VAT – a harmonised approach

The EU VAT Directive contains the charging provision for the harmonisation of EU VAT. Article 1(2) of the EU VAT Directive states:

> *The principal of the common system of VAT entails the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, however many transactions take place in the production and distribution process before the stage at which the tax is charged.*[60]

The harmonisation of EU VAT required the "fundamental elements of substantive provisions of the tax [being] common to all Member States, even though differences might affect the domestic implementation."[61] Despite this approach, all Member States retained discretionary powers, which were required to be exercised within the limits of general EC principles. The

[57] Van Brederode, R. and Pfeiffer, S. 2015. *Combating Carousel Fraud: The General Reverse Charge VAT* in *International VAT Monitor* (May/June 2015), at par 3.8.
[58] Goeydeniz, S. 2010. *IFA Research Paper: VAT on Cross-border Services*, at 17.
[59] Ibid.
[60] Council of the European Union. *Council Directive 2006/112/*EC, at Article 1(2).
[61] Bizioli, G. 2009. *Comparative Analysis of the Causes of Double (Non-) Taxation in the Income and VAT/GST contexts* in *Value Added Tax and Direct Taxation: Similarities and Differences*, at Part IV (2).

harmonisation of VAT is a somewhat inaccurate description, as it relates primarily to a harmonised framework that must be adhered to by all member states.

The three primary causes of double VAT taxation in a VAT harmonised context are:

> *"(1) Discretionary domestic normative power retained according to the VAT directive, in particular in order to define the place of supply and/or the subjective and objective elements of the transaction; (2) interpretive conflicts; and (3) characterization conflicts."*[62]

Therefore, despite the harmonised framework that is widely in place today, inconsistencies still exist between the local legislation of member states. The harmonisation process requires the coordination of legislative and administrative competencies in order to avoid situations of market distortions and remove barriers to trade between member states and thus promote a tax neutral internal market.[63]

There are a number of drawbacks to a harmonised approach to VAT, most notably that "the more complex and tight the relationship between the parties, the more complicated it is to modify something in the common VAT system."[64]

The EU system, while relatively efficient in its application, also has certain flaws and onerous provisions relating to the verification of details. For example, where a customer is established in more than one Member State, the supplier must examine the nature and use of the service provided in order to identify to which of the customers fixed establishments the service is provided. These provisions were all introduced to curb the spread of fraud that has been prevalent throughout the EU as a result of schemes such as the 'missing trader' scheme, whereby a fictitious company is set up and input VAT claimed, only to have the company disappear a few months later.

The advantages of a harmonised approach would invariably need to be weighed against the individual needs and expectations of the state concerned. The harmonised EU system has been developed and refined over decades to result in the relative efficiency of today. As with any system of law, there will be those that attempt to challenge it, and whilst they may succeed in certain instances, it is important for legislating nations to keep abreast of new developments, mechanisms and policies that restrict these challenges.

Given the time that it has taken to develop the EU system into what it is today, it is difficult to determine whether such policies, from an application as well as an implementation perspective, would be effective in the developing countries of Africa.

There is, however, no doubt that there is a need to update and possibly coordinate the current legislation of many of the developing African countries to avoid the incoherent and uncoordinated implementation of the same common principles[65] – the question is whether or not Africa has the infrastructure and legislative ability available to facilitate such transformation.

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[62] Ibid.

[63] Englisch, J. *Tax Coordination between Member States in the EU – Role of the ECJ* in *Horizontal Tax Coordination* (IBFD 2012), at par 1.1.

[64] Kolozs. B. 2009. *Neutrality in VAT* in *Value Added Tax and Direct Taxation: Similarities and Differences*, at Part I.

[65] See one such specific example as set out in Chapter 3.4 below.

Chapter 3: VAT treatment of imported services in Africa

3.1 Cross-border VAT

The supply of services across borders has, as a result of globalisation, become a difficult concept from a VAT, and a VAT neutrality perspective. The ease with which services are transferred electronically between states has inadvertently led to a need to update VAT legislation in line with these developments.

The South African VAT Act defines services as "anything done or to be done, including the granting, assignment, cession or surrender of any right or the making available of a facility or advantage but does not include goods or money."[66] This definition creates a 'catch-all' category and thus has very wide application.

Similarly, article 24 of the EU VAT directive defines a service as "any transaction which does not constitute a supply of goods"[67] From the definition in both the South African VAT context and that of the EU, it is clear that legislators have attempted to simplify the treatment of transactions by providing two broad categories. As the EU definition so succinctly defines it, if it is not a supply of goods then for VAT purposes, it is a supply of services.

One of the foremost attractions of an efficient VAT system is that it has the ability to deal with cross-border transactions efficiently and neutrally. By zero rating exports and taxing imports, one is able to ensure that the incidence of the VAT burden is borne by the final consumer and that such VAT is collected in the state in which consumption takes place.[68]

With significant technological development and globalisation, it has become increasingly apparent that, without the advancement of legislation, or greater cooperation between states, VAT systems will be limited in their ability to tax cross-border transactions efficiently and effectively.

3.2 The reverse charge mechanism

The reverse charge mechanism, as set out in Chapter 2 above, is an efficient measure of collection in certain circumstances. Where the reverse charge is applied, the VAT liability is shifted from the supplier to the customer, as such, one of the principal applications of the reverse charge mechanism is that it is used to collect VAT on cross-border B2B supplies of services. Further, in most cases it successfully simplifies both compliance and administration if it is applied correctly.[69]

The application of the reverse charge mechanism can best be explained by way of an example:

> In a supply chain of five parties, where the final party is the retailer, the first supply of goods/services from A to B would, under the reverse charge mechanism, mean that B would declare the necessary amount of output tax and at the same time make a corresponding input tax deduction of the same amount. For the subsequent sales from B to C, C would do the same thing. The supply chain would follow this pattern until such time that a sale is made to the business involved in retail sales (ie the B2C transaction) where the VAT would be collected and remitted by the retailer to the tax authorities.[70]

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[66] South Africa. *Value-Added Tax Act No. 89 of 1991*, at Section 1 "services".
[67] Council of the European Union. *Council Directive 2006/112/EC*, at Article 24.
[68] Krever, R. 2008. *Designing and Drafting VAT Laws for Africa* in *VAT in Africa* (Krever, R. et al. 2008), at 9.
[69] Cockfield, A. et al. 2013. *Taxing Global Digital Commerce*, at 79.
[70] Van Brederode, R. and Pfeiffer, S. 2015. *Combating Carousel Fraud: The General Reverse Charge VAT* in *International VAT Monitor* (May/June 2015), at par 3.8.

3.3 The reality in Africa

VAT is becoming increasingly significant in the context of income generation for countries. Statistics from the OECD show that from 1965 to 2013, the total tax revenue of OECD countries as a percentage of GDP increased from 24.8% to 34.1%. In 2014 VAT revenue constituted approximately 20% of total tax revenues for OECD countries.[71] There is, however, the need for the VAT systems of trading countries to complement one another from the perspective of the practical ease of collection as well as the ability to successfully generate revenue through the implementation of their enacted legislation. One of the main measures of a successful VAT system is "the extent to which [it] appl[ies] neutrally across business transactions so as to impose the lightest footprint possible on commercial decision-making."[72] This is also the underlying principle of the concept of tax neutrality.

Unilaterally legislating, particularly in an uncoordinated manner for the benefit for one's own country, invariably creates problems which may not be significant, let alone apparent, at the time of enacting such legislation. The determination of the place of supply of cross-border supplies of services and intangibles specifically, has resulted in a situation whereby more definitive rules and mechanisms for compliance are required to ensure that the current legislation remains enforceable. Once a point is reached where, for example, VAT neutrality is no longer possible and as such, decisions are made based on tax considerations rather than economic factors, there will be a greater need to harmonise VAT systems to ensure that economic integration and subsequent growth, in developing markets especially, is achievable.

Within Africa specifically, it is apparent that countries have adopted their VAT systems based on the potential revenue that each can generate individually. Richard Krever, in the book *VAT in Africa* and specifically the chapter titled *Designing and drafting VAT laws for Africa*, states that "while revenue is an important direct product of the VAT, one of the possible by-products of the tax – improved tax administration – may prove equally or more important in the long run."[73] This is a concept that seems to have been largely overlooked in many African jurisdictions.

It is with this in mind – and with particular regard to the practical example set out below – that in order to create an environment in which developing countries on the African continent can thrive and obtain the full benefit from cross-border trade, similar to that of their European counterparts, it may be necessary to harmonise the approach to VAT across Africa.

3.4 Application of the reverse charge in selected African countries

An analysis of the tax policy of less developed countries, particularly in Africa, presents significantly different applications of similar principles. One tends to find that these particular countries have not developed their international tax policy internally. Based on the application of uncoordinated, and to a large extent incoherent, domestic and international tax rules, it becomes clear that many of these nations have legislated based on the influence exercised by developed countries with which they have economic relations or from some short-term policy considerations.[74] Below is an analysis of how the same rules are applied differently in a number of African countries, followed by a practical example of the application of this principle.

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[71] OECD. 2014. *Tax revenue trends* in *Revenue Statistics 2014*, at 5.

[72] Krever, R. 2008. *Designing and Drafting VAT Laws for Africa* in *VAT in Africa* (Krever, R. et al. 2008), at 9.

[73] Ibid, at 28.

[74] Dubut, T. *Chapter 11: The International Tax Policy of the Least Developed Countries: The Case of the Partner States of the East African Community – Burundi, Kenya, Rwanda, Tanzania and Uganda* in *BRICS and the Emergence of International Tax Coordination* (Brauner, T. & Pistone, P.), at par 11.1.

The summaries below are for comparative purposes only and do not deal with the specific treatment of transactions in any detail.

3.4.1 South Africa

In South African VAT legislation, *imported services* are specifically defined in section 1 of the VAT Act as "a supply of services by a non-resident (or by a person carrying on a business outside of South Africa), to a recipient who is a resident, to the extent that such services are utilised or consumed in South Africa otherwise than for the purpose of making taxable supplies."[75] Therefore, under South African law, the supply of imported services not used by the recipient for the purposes of making taxable supplies will be a vatable supply and the recipient will be liable to account for VAT (in terms of section 7(1)(a) of the VAT Act[76]) insofar as the services are utilised for other purposes. In such instances, no corresponding input tax deduction will be available. Insofar as the services are utilised for taxable purposes, the recipient of the services is entitled to an input tax deduction to the extent that one is available.

Therefore, the application of the reverse charge mechanism, under South African legislation, takes the form of the second variation as set out in Chapter 2 above, namely that it is applied where businesses do not use the imports to make fully taxable supplies.

Services that are imported into South Africa can therefore fall into one of three categories, namely: services imported wholly for non-vatable purposes (ie fully imported services); services imported partially for non-vatable purposes (ie imported services to the extent used for non-vatable purposes); and services imported wholly for vatable purposes (ie no imported services).

3.4.2 Kenya

VAT in Kenya is governed by the Value Added Tax Act, No. 35 of 2013, which came into effect in September 2013. The supply of imported taxable services to a registered person in Kenya is deemed to be made by the importer of such service (ie under the reverse charge mechanism).[77] The registered recipient of the services will, therefore, be liable to account for output tax at the time of supply. Based on the nature of the supply, the recipient will be entitled to a credit against such output tax payable to the extent that such a credit is available.

This represents the correct application of the reverse charge mechanism in practice whereby the recipient is deemed to have supplied the service and is consequently liable to account for output tax on the supply. The recipient will also be entitled to an input tax deduction to the extent that one is available under the Kenyan VAT Act.

Where the recipient of services is not registered for VAT, the supply of services will be deemed to be made by the non-resident person in Kenya. Should the value of supplies exceed 5 million Kenyan shillings in a twelve month period, the non-resident supplier will be required to appoint a tax representative in Kenya.[78]

[75] South Africa. *Value-Added Tax Act No. 89 of 1991*, at Section 1 "imported services".
[76] *Section 7(1)(a) of the VAT Act is the charging provision and imposes VAT at 14%, subject to exceptions, exemptions, deductions and adjustments, on the supply by any vendor of goods and services in the course or furtherance of any enterprise carried on by him, based on the value of the supply concerned.*
[77] Kenya. VAT Act 2013, at Section 10(1).
[78] PwC. 2014. *Overview of VAT in Africa*, at 70.

3.4.3 Rwanda

In Rwanda, the place of supply of services is determined by reference to the supplier's place of business (ie where the provider has his headquarters in Rwanda, and such headquarters are mostly concerned with the supply of the services) or the place of use or enjoyment (ie where the provider has no headquarters in Rwanda).[79] Imported services are taxed in Rwanda according to VAT Law No. 37 of 2012 (of 09/11/2012), and specifically article 28(2)(b), which defines imported services as "services delivered to a person in Rwanda by a supplier whose place of business is not in Rwanda."[80] VAT on imported services is reverse charged to the consumer/importer of the service. This reverse charge will represent a cost if on-supplied as no corresponding input tax deduction is available to the importer of the service in Rwanda.

3.4.4 Uganda

VAT in Uganda is charged in accordance with the VAT Act, Cap. 349. In terms of the VAT Act, registered taxpayers who receive a supply of services from a non-resident supplier must account for the VAT due on the supply. With effect from 1 July 2011, VAT accounted for on imported services cannot be claimed as an input tax credit on the supply.[81] This will, therefore, result in a cost to the final consumer should the service be on-supplied and consequently result in the incidence of double VAT taxation on a transaction of this nature.

3.4.5 Zambia

VAT in Zambia is governed by the Value Added Tax Act, Cap 331, 1995 and administered by the Zambian Revenue Authority. As far as imported services are concerned, if the non-resident supplier does not appoint a representative in Zambia, or register for VAT, the recipient of the service must account for the VAT on such services. This VAT cannot be claimed as a corresponding input VAT deduction and consequently becomes a cost to the recipient of the services.[82]

Where local representatives are appointed (these will usually be independent third parties), these representatives would charge VAT on services provided by their principal (ie the non-resident supplier). In such instances, the local recipient of the services will be entitled to a corresponding input tax deduction.

3.4.6 Ghana

The VAT system of Ghana is governed by the newly enacted VAT Act (Act 870), which became effective from 8 January 2014. Under this act, the importation of taxable services which are not used in making taxable supplies are subject to VAT. The recipient of the service must account for VAT by means of the reverse charge mechanism. This reverse charge applies to all services that are supplied by a non-resident business, and received by a resident taxable person for consumption in Ghana. The reverse VAT on imported services is not claimable as an input deduction.[83]

It is clear from the above the negative effect that the differing application of the same principle can have on the cross-border trade in services. Below is a practical example of the

[79] Rwanda. 2012. *Law no. 37/2012 of 09/11/2012* (RRA), at Article 1(7).
[80] Rwanda. 2001. VAT Code 2001, at Article 28(2)(b).
[81] PwC. 2014. *Overview of VAT in Africa*, at 180.
[82] Ibid, at 189.
[83] Ibid, at 56.

effect that uncoordinated measures such as this can have as a result of the incidence of irrecoverable output VAT on imported services.

3.5 Practical example on the application of the reverse charge mechanism

A professional services entity (Company A), a Rwandan-based entity, would normally enter into agreements with, for example, Rwandan clients. However, in some instances, as part of an engagement with a Rwandan client, certain services will be performed by Company B (an affiliate company based in South Africa). Company B will invoice Company A for its part of the engagement. Company A will then invoice the Rwandan client for the assignment as a whole.

In accordance with the VAT legislation of Rwanda, Company A is required to pay reverse tax of 18% over to the Rwandan Revenue Authorities (**RRA**) for the work performed by Company B as such services are not available in Rwanda. Further, Company A will also have to charge VAT on the combined assignment to the Rwandan client.

The specific VAT legislation of Rwanda states that VAT is charged on taxable imported services at 18%. It provides further that the VAT payable on imported services is paid by the customer/importer of the services. The implication of this is that this amount will invariably be on-charged to the final consumer and will be an additional cost to the recipient of the imported service since it is not claimable as input tax[84] (should the particular foreign service not be available in Rwanda[85]).

In the event that Company B were to invoice the Rwandan client directly, it would firstly be necessary that this was stipulated expressly in the agreement with Company A. Should this be set out expressly, it would be possible for Company B to invoice the Rwandan client directly for this portion of the work. In this instance, the Rwandan client would be required to account for 18% reverse VAT on invoices paid to Company B.[86] Article 12 of Law no. 37/2012 of 09/11/2012 provides that "if a taxpayer gets services from a person who is outside Rwanda, the taxpayer is considered as if he/she has delivered taxable services and has received an output tax from that person residing outside Rwanda."[87]

3.6 Need/possibility for harmonisation

As is the case with direct taxes, where a country wants to tax a transaction, it is required to find a nexus in order to do so. As set out briefly above, this could be on the basis of the destination principle/place of consumption or on the origin principle/place of supply.[88] There is general consensus that the cross-border trade in services should be taxed according to the rules of the place of consumption.[89] That being said, one of the primary characteristics of VAT is that it is a tax on the final consumer. It follows therefore that double VAT taxation (or non-taxation) should, in principle, not exist.

The reason it does exist, however, stems from differing opinions, short-term policy considerations, implementation or interpretation of specific transactions which can all result in differing results relating to where consumption occurs for the purposes of levying VAT. Thomas Ecker explains in his book *A VAT/GST Model Convention*[90], that "the most common reasons for VAT double taxation are therefore:

[84] Rwanda. 2012. *Law no. 37/2012 of 09/11/2012* (RRA).
[85] Services are considered not to be available in Rwanda if there is no person who can deliver identical or similar services on the local market. (RRA, at Article 12)
[86] Rwanda. 2012. *Law no. 37/2012 of 09/11/2012* (RRA), at Article 12.
[87] Ibid.
[88] Verstraeten, A. *Double (Non-) Taxation in VAT and Direct Taxes: Which Tax Is Better For Developing Countries*? in *Value Added Tax and Direct Taxation: Similarities and Differences* (IBFD 2009), at Part IV (1).
[89] Ibid.
[90] Ecker, T. 2013. *A VAT/GST Model Convention* (IBFD 2013).

- The use of different rules to determine the place of taxation;
- Different interpretation of (otherwise similar) place of taxation rules, the order of these rules, or a different interpretation of the surrounding key proxies and concepts for determining the place of taxation; and
- Different characterization of a supply (even if similar rules are in place to determine the place of taxation) due to different interpretation of the underlying facts."[91]

As a result of differing applications and implementations of the reverse charge on imported services, a situation is created whereby the reverse charge could represent a cost to the final consumer. The corresponding input VAT that should be allowed (in theory), is restricted in certain instances as a result of the policy decisions of the particular state.

It is clear from the example above, the effect that policy decisions and *soft law*[92] can have on the application of principles that have been developed, and are practiced in a relatively similar manner universally. In such situations there is the possibility of losing the neutrality of a system, as trading entities will lose their competitive advantage as a result of the double VAT taxation which will, in all likelihood, become a cost to the final consumer.

3.7 Harmonisation

The movement towards a harmonised tax system has already begun in the East African Community (**EAC**)[93] with its inclusion as part of the EAC integration agenda under which there is a move to harmonise monetary and fiscal policies in the region. The key objective is to minimise and even eliminate tax distortions in order to allow for the efficient allocation of resources through the enhancement of trade.[94] This is simply one indication of the need for greater development of tax legislation in Africa.

A further problem that is faced by developing countries in Africa is that the implementation of these policies and developments require infrastructure which is, to a large extent, unavailable in Africa. As a result, there is the inability to efficiently manage data and consequently, a greater level of technological development is necessary.

It is as a result of the above factors that the implementation of soft law and policies to advance the tax systems of developing countries will prove costly and time consuming. Further, whilst this may be an unrealistic target for many of these nations in the near future, the work currently being done by the EAC shows that there is an emphasis being placed on the need to coordinate measures to ensure an efficient allocation of resources for the development of Africa as a whole, rather than the unilateral disconnect that we have seen in the past.

[91] Ecker, T. 2013. *A VAT/GST Model Convention*, at Chapter 2.3.
[92] "Soft law is a much broader legal category which includes any type of social rule or any principle lacking an actual binding force, but nevertheless capable of exercising some kind of suasion on the addressees to comply with it on a voluntary basis."(Pistone, P. 2009).
[93] The EAC is a regional intergovernmental organisation of the Republics of Burundi, Kenya, Rwanda, Tanzania and Uganda (Dubut, T. 2015).
[94] Dubut, T. 2015. *Chapter 11: The International Tax Policy of the Least Developed Countries: The Case of the Partner States of the East African Community – Burundi, Kenya, Rwanda, Tanzania and Uganda* in *BRICS and the Emergence of International Tax Coordination* (Brauner, T. & Pistone, P. eds., IBFD 2015), at par 11.1.

Chapter 4: Double VAT taxation – further solutions for potential avoidance

4.1 Introduction

As illustrated above, double VAT taxation can occur where two states levy VAT on the same supply, or where VAT is imposed more than once on the same transaction.[95] Where one particular incidence of VAT is irrecoverable, the cost will be borne by the final consumer. Consequently, this would occur in most circumstances as a form of *economic double taxation*[96].

It is important to note, based on the premise that consumption taxes allocate the exclusive right to tax to the jurisdiction in which consumption occurs, that double VAT taxation should not occur as a result of the overlapping of taxing powers of two states.[97] The primary cause, therefore, lies in different applications of the consumption (or destination principle), which leads to different understandings of where consumption takes place.

As such, the incidence of double VAT taxation, as set out in Chapter 3 above, should not occur in principle. Due to the very nature of VAT as a tax on consumption, double VAT taxation should not be a structural problem. However, due to the multi-staged collection process of VAT, where any particular incidence of VAT is not recoverable along the supply chain, the tax base for the supply to the final consumer will include tax on tax.[98] Therefore, if the consumption principle is adequately implemented, the nexus or place of supply used to determine where VAT is levied should be irrelevant.[99]

The principle of harmonisation has proven itself to be an effective means where the infrastructure and application allow it to be effectively applied in a particular region. That being said, where harmonisation fails to remove a particular incidence of double VAT (non-) taxation, one needs to look to other means to resolve such disputes over the taxing rights to a particular transaction.

The problem arises where, for example, one state taxes a supply based on the application of the reverse charge, but the other does not; or, as is set out above, the reverse charge mechanism is applied but due to an uncoordinated unilateral application of the mechanism, no corresponding input tax credit is offered to the taxpayer. This subsequently results in the on-charging of VAT to the final consumer.

As set out in Chapter 3, one of the major issues facing cross-border trade between African nations is the lack of coordination between the VAT/GST legislation of countries. This creates compliance difficulties and a lack of certainty, particularly with regard to the irregular manner in which legislation has been promulgated and to which it has been given effect (ie for the unilateral benefit of an individual state). This situation has arisen as a consequence of differing interpretations of a particular situation by the tax authorities of two states, as well as the need to implement legislation favourable to each state's own economic development.[100]

[95] Ecker, T. 2013. *A VAT/GST Model Convention*, at par 2.2.
[96] *Economic double taxation* can be explained as a situation where income or capital is taxed in two or more states during the same period in respect of the same transaction, but usually in the hands of different taxpayers. (Olivier, L. and Honiball, M. 2009. *International Tax – A South African Perspective*, at 841).
[97] Bizioli, G. 2009. *Comparative Analysis of the Causes of Double (Non-) Taxation in the Income and VAT/GST contexts* in *Value Added Tax and Direct Taxation: Similarities and Differences*, at Part IV (1).
[98] Ecker, T. 2013. *A VAT/GST Model Convention*, at par 2.2.
[99] Goeydeniz, S. 2010. *IFA Research Paper: VAT on Cross-border Services*, at 30.
[100] Ibid.

There have been many contrary positions taken with regard to the best possible way to resolve conflicts relating to the right to impose VAT on a particular transaction. It has been suggested, for example, that an article could be inserted into the OECD Model or similar convention, and consequently over time, negotiated and incorporated into bilateral double tax agreements (**DTA's**) undertaken between states. It has also been suggested that a standalone Model Treaty on VAT should be drafted.[101]

Further, there are a number of other, more feasible options to resolve the issue of double VAT taxation. The OECD Model (although generally not applicable to VAT), contains two possible solutions for the avoidance of double taxation which are set out in articles 23A and 23B. Article 23A resolves the incidence of double taxation through the residence state exempting income earned in the source state (the exemption method). Whereas article 23B provides for where the residence state is required to provide a credit for the tax paid in the source state against the taxpayer's domestic tax liability (the credit method).

There are, therefore, a number of possible mechanisms and principles that could be implemented as a means through which to provide an effective means to resolve disputes relating to double VAT taxation. These are set out in more detail below.

4.2 Further means by which to resolve the possible incidence of double VAT taxation

4.2.1 Credit or exemption method as set out in the OECD Model Convention

Background

As set out briefly above, the credit and exemption methods are used as a means to resolve taxing conflicts between residence and source and are set out in articles 23A and 23B of the OECD Model. Conflicts between residence and source arise where both the source state and the residence state may have a right to levy tax. The credit and exemption methods will then provide, through either a credit or an exemption respectively, a means by which to resolve the conflict.

The exemption method involves the residence state having to exempt the income taxable in the source state from the taxpayer's domestic tax calculation, whereas the credit method entails the residence state providing a domestic tax credit to the taxpayer in respect of the tax paid in the source state.[102]

Applicability

The applicability of these articles to VAT, as a consumption tax, are unfortunately limited as the taxing rights for VAT purposes are granted where the supply is deemed to be consumed under the destination principle. Obviously, in most transactions, there can be only one true place of consumption and as such, there should theoretically, be no need to divide taxing rights between states in accordance with either method of relief.

The state in which consumption is deemed to occur will receive the right to tax, while the other state would, consequently, be forced to exempt the transaction. There would, therefore, be no benefit to an exemption-method equivalent for the purposes of resolving incidences of double VAT taxation as, due to the very nature and application of the destination principle, this is already achieved.

[101] Verstraeten, A. *Double (Non-) Taxation in VAT and Direct Taxes: Which Tax Is Better For Developing Countries*? in *Value Added Tax and Direct Taxation: Similarities and Differences* (IBFD 2009), at Part IV (1).
[102] OECD. 2014. *Model Tax Convention on Income and on Capital*, at Articles 23A and 23B.

Further, the credit method, while having a greater benefit in that it is able to successfully avoid unintentional double non-taxation[103], the application thereof will be a significant administrative and compliance burden as taxpayers would have to declare and eventually pay VAT in all states involved in the particular transaction. Furthermore, the documentary requirements that may be necessary and required in order to obtain the corresponding credit in the state of origin would also place a further burden on the supplier.

This would therefore be contrary to the fundamental principles of a VAT and would ultimately lead to a less effective, less efficient and more complex VAT system. It would result in a more competitive, and thereby less neutral, marketplace and potentially discourage trade. It is clear from the above that there is no need, nor applicability for these two methods in the context of the prevention of double VAT taxation.

4.2.2 Domestic law possibilities

4.2.2.1Section 6quat of the South African Income Tax Act

Background

Section 6*quat* of the South African Income Tax Act (**the IT Act**) provides a unilateral tax credit in respect of foreign taxes on income. This mechanism is available to South African residents only, and represents a means of unilateral relief through domestic legislation.

This provision provides the residence country with an effective residual right to tax income derived by its residents from a foreign source. Certain requirements must be met in order for foreign taxes to be regarded as 'qualifying foreign taxes' for the purposes of this section. The taxes must be: (1) payable on income; (2) proved to be payable to any sphere of government of any country other than South Africa in respect of an existing foreign tax liability; (3) payable without any right of recovery by any person; and (4) payable on amounts included in the residents taxable income.[104]

Applicability

Generally the person who is liable to pay the foreign tax would therefore be the person entitled to claim the foreign tax rebate. However, in certain circumstances, a resident is permitted "to take an amount of foreign tax into account notwithstanding that another person was liable for the amount of foreign tax."[105]

Despite the fact that VAT is specifically excluded and not considered to be a tax on income, this does not mean that the principles could not be implemented to resolve some of the conflicts faced, particularly in the African context. As such, the application of the section 6*quat* credit could effectively

[103] In order for the credit method to be applicable, both states will, effectively, tax a specific transaction. However, the state in which consumption is ultimately deemed to occur will have the taxing rights in respect of the transaction. The supplier would therefore, on application of the credit method, receive a credit in the origin state in respect of tax paid in the destination state, resulting in a net VAT result of nil in the origin state. This will, therefore, avoid any unintentional double non-taxation as, where no VAT is paid in the state of consumption, no VAT credit will be available in the state of origin and hence the transaction will be subject to at least one VAT. (Ecker, T. 2013. *A VAT/GST Model Convention*, at Chapter 19).

[104] South Africa. *Income Tax Act, No. 58 of 1962*, at Section 6*quat* (1A).

[105] South Africa. South African Revenue Service. 2015. *Interpretation Note No. 18 (Issue 3) (26 June 2015) – Rebates and deduction for foreign taxes on income*, at 34.

resolve instances such as those experienced due to the inconsistent application of the reverse charge mechanism.

4.2.2.2Section 6quin of the South African Income Tax Act

This section of the IT Act provides a rebate in respect of foreign taxes on income from a source within the Republic, and states that, subject to exceptions, where

> *Any portion of the taxable income of a resident is attributable to an amount that is from a source within the Republic and is received by or accrued to that resident in respect of services rendered within the Republic, and an amount of tax is [levied or imposed by another country], a rebate [as set out in the legislation] must be deducted from the normal tax payable by that resident.*[106]

This section essentially sets out the correct functioning of the reverse charge mechanism in practice. As set out in Chapter 2 above, in the EU application of the reverse charge mechanism the customer is required to declare output VAT on the purchase of imported services, and is consequently entitled to a corresponding input VAT deduction. Therefore, given the nature of the rebate in section 6*quin*, its applicability does not expressly serve to resolve instances such as those experienced due to the inconsistent application of the reverse charge mechanism. It could, however, find application to different examples of double VAT taxation.

4.2.3 Potential inclusion of an article into the OECD Model or a standalone VAT treaty

There has been much discussion around the practical feasibility of a treaty for the avoidance of double VAT taxation. The difficulty arises through the significant differences in the domestic VAT legislation of different states. It would therefore be incredibly difficult to account for, and to provide a possible resolution, for the varied applications of principles and many inconsistencies that are prevalent between states.

As discussed, the two rationales for the levying of income tax are on the basis of income attributable to a residence state or a source state. In the case of VAT, the only rationale that can be used is that of the place of consumption. In order therefore, to insert a provision in, for example, the OECD Model, or to introduce a standalone VAT treaty, it would need to successfully allocate taxing rights to one country rather than divide taxing rights, and as such "the distributive rules should [be able to] mirror an agreement of the contracting states where a supply should be deemed to be consumed."[107]

Proxies are utilised in order to assist in the determination of the place of consumption. It is through the use of these proxies that any conflict regarding the right to tax a particular transaction should be resolved. Therefore, rather than the inclusion of a particular method that distributes taxing rights, an agreement would need to be reached on the most effective, and universally applicable proxies, that can be applied reliably to most types of transactions to resolve these conflicts.

Should such a provision be incorporated into the OECD Model, or a standalone VAT Treaty introduced, there would be no need to consider the efficacy of, for example,

[106] South Africa. *Income Tax Act, No. 58 of 1962*, at Section 6*quin*.
[107] Ecker, T. 2013. *A VAT/GST Model Convention*, at Chapter 19.

the credit method. The provision/treaty would need to be drafted broadly and incorporate the necessary proxies, but essentially would aim to allocate taxing rights exclusively to the state in which consumption is deemed to occur.[108]

It would be necessary to clearly set out the applicable proxies for the relevant categories of supplies. It would also be necessary to include a 'catch-all' provision for unique or highly specialised transactions. The relevant proxies would ensure that the parties to the transaction are able to objectively determine the location of consumption, and therefore that the taxing rights to the transaction are clearly attributable to only one state.

4.2.4 Mutual Agreement Procedure (MAP)

A further option would be to create a version of the MAP article of the OECD Model and include the scope to resolve potential VAT disputes, or increase the scope of the OECD Model to include VAT. This article would also be necessary in order to resolve conflicts that arise despite the presence of various possible solutions. Invariably, given the nature of business and the scale of globalisation, exceptions to general rules will always present themselves and the ability to correctly apply standardised universal rules will fall short of acceptable and required methods of treatment for such transactions from a VAT perspective.

Article 25(3) of the OECD Model currently sets out that "[The Competent Authorities of the Contracting States] may also consult together for the elimination of double taxation in cases not provided for in the Convention."[109] This article is, in its current form, the only article in the OECD Model that has the scope to handle disputes relating to VAT as it includes *cases not provided for in the Convention*. This article can therefore be applied to situations of VAT double taxation and therefore extends the scope of the OECD Model to include, as is relevant in this case, VAT.

Despite the extended scope of article 25(3), the arbitration provision in article 25(5) only applies to MAP procedures in terms of 25(1) and (2). As such, article 25(3) does not ensure that a result will be obtained or any issue resolved. Currently, in these instances, it would be necessary to rely on the good will of the administrations to assist in resolving any dispute – although there is no obligation on them to do so. Consequently, this provision "usually does not grant taxpayers any rights but rather rests on the discretionary power of the tax authorities."[110]

By way of example, this may be particularly relevant in situations where a place or location extends across a number of different states, for example, pipelines or bridges, or services that form part of supplies that are performed in more than one state. In these limited instances, it may be most effective to divide the taxing rights between states, however a practical and comprehensive MAP article could resolve this by allocating or dividing taxing rights in such situations.[111]

It would, therefore, in addition to a possible amendment of article 25(3) to specifically account for VAT disputes, be an invaluable addition, either to a standalone VAT treaty or in amending the current OECD Model, to increase its scope to include an article 25(3) equivalent under the binding arbitration mechanism of article 25(5). This will, in the very least, ensure that exceptions to generally accepted practice can be dealt with

[108] Ibid.
[109] OECD. 2014. *Model Tax Convention on Income and on Capital*, at Article 25(3).
[110] Ecker, T. 2013. *A VAT/GST Model Convention*, at Chapter 3.4.
[111] Ibid, at Chapter 19.

expediently and in the proper forum to allow for the prompt resolution of VAT disputes, and introduce a higher level of certainty.

South Africa has recently ratified two treaties with Swaziland and Lesotho respectively on mutual assistance and co-operation and the prevention of fiscal evasion with respect to Value-Added Tax.[112] These treaties do not provide specific mechanisms to resolve double VAT taxation, but do provide for a *Resolution of Difficulties* clause in Article 7 – similar to that of article 25(3) of the OECD Model. The treaties do not, however, allow for an article 25(5) OECD-equivalent and thus do not provide any right to the taxpayer to have a particular dispute resolved.

Therefore, whilst having the capacity to deal specifically with international VAT disputes between contracting states, the provisions of these treaties do not ensure that a result will be obtained or any issue resolved. It would, once again, be necessary to rely on the good will of the tax authorities to assist in resolving a dispute without any obligation on them to do so.

The ratification of these two treaties is a seemingly positive step in the right direction, however, it remains to be seen whether they will generate any form of success until such time that the right to have a dispute resolved is provided to the taxpayer.

4.2.5 The OECD International VAT/GST Guidelines

As has been discussed extensively in this paper, the Guidelines set out and emphasise the need to maintain the generally accepted principles of tax policy. The principle of neutrality, which is central, particularly to the application of the destination principle and place of taxation, has already been discussed above. The other principles include: efficiency, certainty and simplicity, effectiveness and fairness, and flexibility. These are the core characteristics of a successful tax system and can be used to guide legislators in achieving and promoting mechanisms and laws which allow for the consistent application of VAT, particularly in cross-border transactions. This will allow for the successful interaction of VAT systems internationally and maintain the essential characteristics of the tax on a global scale.

Despite being in its relative infancy, the Guidelines have initiated much-needed discussions on the development and advancement of VAT systems in line with its principles. It is a vital starting point to begin to provide VAT/GST with the attention that income tax has seen over the years that has allowed direct taxes to develop to such an extent (ie through the development of an extensive treaty network between countries and an increase in case law as a result of disputes that have arisen in this regard). Most notably, therefore, "there now seems to be consensus among the OECD Member States to set up some form of coordination in the sphere of consumption taxes as well, thus allowing them to evolve to the same standards reached for direct taxes."[113]

4.3 Conclusion

As set out in Chapter 1, one of the major characteristics of an efficient and certain international VAT system is the principle of neutrality. The author believes that the favoured application of the destination principle is warranted as it provides for a final tax according to the rules of the customer's jurisdiction, and it therefore ensures that businesses are driven by

[112] These treaties were ratified on 27 January 2015 (Swaziland) and 29 October 2014 (Lesotho).
[113] Pistone, P. 2009. *Soft Tax Coordination: A suitable Path for the OECD and the European Union to Address the Challenges of International Double (Non-) Taxation in VAT/GST Systems* in *Value Added Tax and Direct Taxation: Similarities and Differences*. (IBFD 2009), at Part I.

economic, rather than tax considerations – which ensures – where such application comes into fruition – that the principle of neutrality is maintained.

It is further clear, from the discussions in Chapter 3 that the consequence of unilateral legislating in Africa prevents such neutrality being achieved.

In systems such as the EU, due to its close connection with the OECD and extensive soft law influence, they tend to have a strong correlation with the principles and values embodied in the Guidelines. In addition, it is apparent that, over the years of developing the EU VAT system, it was drafted with these principles in mind. An example of this is that the scope of EU VAT was drafted in a deliberately broad way in order to achieve the highest degree of simplicity and neutrality.[114]

That being said, and following years of successful application within the EU, a harmonised VAT has not been able to eradicate the incidence of double VAT (non-) taxation for reasons, many of which, have been discussed above. Where coordinated unilateral measures fail, there may be a need to address the issue with the implementation of binding instruments which can be developed and integrated into dispute resolution mechanisms such as is available in the case of direct taxes.

[114] Aujean, M. 2008. *Application of VAT to Public Bodies: the EU VAT System, Current Issues and Proposals* in *VAT in Africa* (Krever, R. 2008), at 71.

Chapter 5: Conclusion

5.1 Possibility of harmonisation

From the above it is clear that the harmonisation of VAT, whilst successful in the EU, can provide significant issues for nations not equipped to deal with the procedural and compliance-related burdens that go hand in hand. In addition, the applicability of such a system must be tested against the viability of its implementation in developing countries where the reliance on VAT revenues generated through transacting is far greater than in developed countries where there is a greater emphasis placed on the revenue generation from income tax.

In developing countries such as the African nations discussed in this paper, the availability of resources, and cross-border trade, is a major contributor to the GDP of these countries. It is for this reason that the VAT associated with such transactions is of great importance to ensure the successful distribution of these resources.

It goes without saying that the avoidance of double VAT (non-) taxation is of great importance. The emphasis that is placed on VAT revenues, together with the importance of developing countries to benefit from their resources, means that the market for cross-border transactions is highly competitive. The lack of coordination will result in an increase in the competitiveness of the market and possibly have a negative impact on the trade and consequent revenues of countries that have failed to develop and see the need only for unilateral coordination.

With the progress that is being made by the EAC, as well as the Guidelines on an international scale, it should not be long before harmonised systems of VAT are introduced to regions of Africa. As discussed, the viability from an infrastructure and enforcement perspective would need to be addressed, but as long as the substantive principles of the application of VAT are agreed and enforced, the normative discretionary power within a jurisdiction should not be able to fundamentally alter the taxing result of a particular transaction.

5.2 Reverse charge applicability in Africa

As has been discussed, there is a significant need in African countries to develop domestic offerings of services, and it is therefore understandable that the reverse charge mechanism finds such widespread application. Harmonisation would not remove these mechanisms from domestic VAT legislation, but would simply be a means through which the application and cross-border effect could be controlled and monitored in such a way that VAT neutrality is reached and maintained.

As set out above, the incidence of double VAT taxation becomes a cost for the consumer, which in turn could very easily negatively impact the ability of a particular country to partake in intra-community trade. Africa has not developed to the extent that countries can prevent the much-needed services, which will ultimately benefit both countries, from being freely traded across borders. It is important to create an environment in which African countries can develop alongside one another and progress collectively. This will deteriorate even further if African countries continue to unilaterally legislate with their own benefit in mind. As with the EU system discussed above, a coordinated effort will be the most efficient and effective means through which to encourage trade and VAT neutrality.

5.3 Methods for avoiding double VAT taxation

As discussed above, the Guidelines, represent a significant contribution to international VAT soft law. They effectively set out the substantive characteristics that all VAT legislation and agreements should contain and aim to achieve. As such, there is no doubt that this is the first

move in shifting the focus from the already extensively developed mechanisms for direct taxes, to the significantly underdeveloped area of international VAT.

It is clear that there are many options and methods which can be used to prevent double VAT taxation, and most importantly steer a VAT system into a more VAT neutral position.

The EU VAT Directive has done, and continues to ease the compliance burden for Member States, as well as simplify the statutory obligations and cost of doing business within the EU. I believe that regions of Africa, such as that of the EAC, need to implement such a system in order to gain the full benefit that could result from a freer and inexpensive intra-community VAT regime.

It is only through a more harmonised approach to VAT legislating that the principle of neutrality can be reached. It is important to note that whichever "form of coordination is eventually agreed upon, its effective implementation is likely to require substantial changes in the actual structure of consumption taxes around the world, with a view to removing the existing differences."[115] It is however, only through such change that VAT neutrality will be able to bring about the change that is needed for the development of VAT in Africa.

[115] Pistone, P. 2009. *Soft tax coordination: A Suitable Path for the OECD and the European Union to Address the Challenges of International Double (Non-) Taxation in VAT/GST systems* in *Value Added Tax and Direct Taxation: Similarities and Differences.* (IBFD 2009), at 4.

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